FISCAL POLICY MANAGEMENT & TAX SHARING REFORM

STATEMENT BY

THE HONOURABLE

JOHN WHITE

TREASURER OF ONTARIO AND
MINISTER OF ECONOMICS AND INTERGOVERNMENTAL AFFAIRS

TO THE

MEETING OF THE MINISTERS OF FINANCE

OTTAWA, JANUARY 18-19, 1973

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I INTRODUCTION

Mr. Chairman and fellow Finance Ministers, I look forward to our discussions and sincerely hope that we can agree on a positive course of action at this meeting. There are many important items on our federal-provincial agenda, but, in my view, two are paramount. First, there is the immediate need for bold programs to reduce unemployment, reinforce economic expansion, and contain inflation. Second, there is the urgent need for redistribution of tax resources to the provinces in order to avoid otherwise inevitable tax increases and cuts in essential public services. These priority objectives can be met by a single fiscal reform on the part of the federal government — a major reduction in personal income tax. The Government of Ontario now urges a $1 billion tax cut to provide immediate stimulus to private incomes, economic expansion and employment, and also to open up essential tax room for the provinces over the longer run.

II FISCAL POLICY MANAGEMENT

The economic record of the past year has been most unsatisfactory. Today, after four years of federal attempts to stabilize the economy we are worse off than before, with unemployment averaging 6.3 per cent in 1972 and the rate of price inflation reaching 4.8 per cent. In the fourth quarter of 1972, the seasonally adjusted rate of unemployment reached 6.7 per cent. The economy has suffered permanent losses in jobs and incomes, and the goal of full employment is as distant as ever.

In 1969 the federal government implemented deflationary monetary and fiscal policies to stem the rising tide of inflation. At that time, you may remember, the Consumer Price Index had risen by 4.5 per cent over 1968, continuing a rising trend from 1966 when a gain of 3.7 per cent was recorded. The rate of unemployment averaged 4.7 per cent in 1969, which itself is not a low level in terms of the economy's potential. The impact of restrictive policies was immediate and dramatic. In 1970, the rate of price inflation declined to 3.3 per cent but the rate of unemployment rose to 5.9 per cent. These trends continued in 1971 and unemployment rose to a ten-year high of 6.4 per cent. Thus, for almost three years running we have been experiencing levels of unemployment in excess of 6.0 per cent.

This situation must not continue.

The Economic Council has tabled medium-term goals of 6.0 per cent real growth, 4.5 per cent unemployment by 1975 and an average rate of inflation of 3.0 per cent over the 1972-75 period.[1] These goals are themselves a compromise between what is attainable and the unsatisfactory record of recent years. In any case, we are moving away from these goals instead of toward them. The goals are to be applauded, but the economy needs immediate and significant relief if they are to be attained. Ontario believes that we should and can regain full employment before 1975 if the federal government will use the maximum fiscal leverage at its disposal.

The Federal Record

During the past four years Ontario has carefully monitored the progress of the economy and examined the economic and fiscal policies of the government sector in Canada. We have found much lacking in the conduct of federal fiscal policy.[2] The record shows that the actual fiscal impact of federal policy has been much less than we have been led to believe in successive budget statements. An examination of the course of federal fiscal policy

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1. Economic Council of Canada, Ninth Annual Review: The Years to 1980 (Ottawa: 1972).
2. Hon. W. Darcy McKeough, The Reconstruction of Economic and Fiscal Policy in Canada (Toronto: Department of Treasury and Economics, 1971).

since 1970 reveals a poorly planned and unco-ordinated variety of measures that have almost totally failed in reaching their objectives.

Let me document for you the major shortcomings of federal policy since 1970.

The March, 1970 Budget correctly predicted a deceleration in the rate of growth in output as well as some increase in unemployment. It is history now that the rate of unemployment rose rapidly during the year, averaging well over 6.0 per cent in the second half of that year. Cash requirements in the March Budget were a modest $525 million. This figure was revised upwards in the December, 1970 Budget to $1.6 billion as plans for additional spending were introduced in response to the deteriorating situation. The December, 1970 Budget message stated:

> Of prime importance is the fact that employment is rising in Canada and unemployment on a seasonally adjusted basis appears to be falling. [3]

Tax cuts were ruled out as a policy measure because:

> A reduction in taxes would be stimulating, that is not to be doubted. But the positive programs which I have described **will** not only be stimulating but will penetrate more surely to the particular points of the economy where stimulus and relief of economic hardships are most required. [4]

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3. Hon. Edgar J. Benson, Budget Speech (Ottawa: December 3, 1970).
4. Ibid.

The fiscal impact of the 1970-71 financial program fell far short of intentions. Actual cash requirements were below expectations, reaching $1 billion as compared with the $1.6 billion forecast. The shortfall was, in fact, considerably greater than indicated as revenues fell by more than $400 million below forecast because of greater than anticipated weakness in the economy. Thus, a combination of delays in recognizing the urgency of the problem and of carrying out policy, once determined, rendered fiscal policy virtually impotent in 1970-71.

The same tale unfolds in fiscal 1971-72. The June, 1971 federal Budget again took an optimistic view of the unemployment situation:

> Unemployment is now well below its peak of last fall and the trend will continue downwards.[5]

This optimism dissipated rapidly, with the stronger upsurge in unemployment in the last five months of the year, and the June Budget forecast of total cash requirements of $2.4 billion was raised to $2.6 billion in October. The final cash requirements and fiscal impact figure for the year was, however, about $1 billion lower, even though the June Budget belatedly eliminated the 3 per cent personal and corporate income tax surcharges.

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5. Hon. Edgar J. Benson, Budget Speech (Ottawa: June 18, 1971).

In our 1971 Budget, two months earlier, Ontario had recommended the elimination of these surtaxes. Further, we urged additional tax cuts:

> We believe that immediate and significant tax cuts are required in two main areas:
>
> - first, personal income taxes should be cut in order to bolster consumer purchasing power; and,
> - second, corporate taxation should be reduced in order to restore business confidence and stimulate investment and economic growth.[6]

It was not until the October 14 emergency measures were introduced that the federal government introduced temporary personal and corporate income tax cuts (3 per cent and 7 per cent respectively). The personal income tax cut was immediately matched by Ontario. The Province had already moved on the corporate side with a 5 per cent corporate investment tax credit in its April, 1971 Budget.

As I pointed out before, with actual cash requirements once again well below expectations, federal fiscal policy in 1971-72 was far less stimulating than desired. The situation in fiscal 1972-73 is little better. In our own 1972 Budget, in March, we said:

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6. Hon. W. Darcy McKeough, Ontario Budget 1971 (Toronto: Department of Treasury and Economics, 1971) p. 24.

> It is not axiomatic that the only way out of the unemployment problem is through inflated public spending.[7]

Yet, in terms of measures directed to the short-term stimulation of the economy, the emphasis on increases in spending was continued in the May 8th Budget. The federal Budget message exuded confidence:

> Summing up, the Canadian economy is expanding firmly and steadily ... the mood of the economy is one of growing confidence ... confidence is contagious and I believe it is spreading.[8]

And, on unemployment:

> I expect that unemployment will fall on the average in the course of this year ... We do not expect that food prices will rise as fast this year as last ...[9]

As you are all aware, following this Budget the unemployment rate climbed steeply and it has averaged 6.3 per cent for 1972. Thus, in 1972 we experienced intolerably high levels of unemployment for the third straight year. The Consumer Price Index recorded a gain in 1972 greater than that of 1969 when the battle began, and food prices recorded the largest increase. After looking at the record of federal policy we are inclined to think that federal budget messages have a rather dramatic perverse influence on the economy!

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7. Hon. W. Darcy McKeough, Ontario Budget 1972 (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1972) p. 20.
8. Hon. John N. Turner, Budget Speech (Ottawa: May 8, 1972).
9. Ibid.

We are led to understand that cash requirements for the current fiscal year will be about $2 billion. On the basis of past performance, I would be inclined to disregard this forecast and anticipate a lower figure, not greater than that for 1971-72. Excluding U.I.C. transfers, cash requirements so far have amounted to less than $400 million. In addition, the greater elasticity of the new tax system is generating extremely strong revenue flows. Therefore, apart from the unplanned and enormous U.I.C. drain - which is admittedly stimulating spending - federal fiscal policy plans appear to have fallen flat again this year.

Ontario's Record

By comparison, let me review the financial dimensions of Ontario's expansionary fiscal position over the past three years and the outlook for the upcoming year. Since 1970-71, our cash requirements relative to total revenues have far exceeded those of the federal government. But, having maintained an expansionary policy stance for the past three years, the Ontario Government now finds it imperative for reasons of budgetary control and future fiscal policy flexibility to reduce the level of its overall cash deficit. In the upcoming year, notwithstanding

severe expenditure restraint, our total cash requirements in the absence of tax increases will be around $1 billion for the third consecutive year. We simply cannot afford stabilization costs of this magnitude. Yet, in 1973-74, Ontario's fiscal effort is projected to exceed by far that of Ottawa if no significant federal initiatives are taken.

	69/70	70/71	71/72	72/73**	73/74**
Federal cash requirements*					
($ billion)	0.2	1.2	1.7	1.7	1.0
- per cent of gross budgetary revenue	1.5%	9.2%	11.8%	10.8%	5.6%
Ontario cash requirements					
($ billion)	0.2	0.6	1.0	1.0	1.1
- per cent of gross budgetary revenue	5.4%	10.9%	18.8%	16.3%	17.0%

* Excluding foreign exchange requirements.
** Estimated, Ontario Treasury.

The Outlook for 1973-74

Looking to the upcoming fiscal year, federal cash requirements are currently forecast to be substantially reduced. Surely this is unwise. It seems to indicate that the federal battle to create jobs is over. In my opinion, the record of the past three years shows that it

has hardly begun. I urge the federal government to move with courage and conviction in designing its fiscal plan for 1973-74, and to learn from past experience. The economy needs a substantial personal income tax cut to take up the slack. In return, the Government of Ontario pledges its co-operation in any short-term anti-inflationary measures that might be required. In making this pledge we are recognizing the federal government's continuing concern with inflation.

In planning an appropriate fiscal policy stance for 1973, the federal government must consider the fiscal drag associated with the new tax system and the provincial-municipal tax position. As my predecessor correctly anticipated during the debate on tax reform, there is mounting evidence that the new tax system is considerably more elastic than the old. In the first nine months of 1972, federal revenues from the personal income tax were running 27 per cent ahead of the same period in 1971. The increase in the whole of 1971 over 1970 was 15 per cent. The greater elasticity of federal revenues under this new system has obviously neutralized the fiscal stimulation intended in the last federal budget. It is of considerable importance that this revenue drag be offset by appropriate initiatives in the fiscal policy field, such as the personal income tax cut I have suggested.

Major Tax Cut Recommended

On January 4th, the Government of Canada, in the Speech from the Throne, assigned the highest priority to reducing unemployment, containing inflation and strengthening the economy.[10] The major specific measures to be undertaken are in fact a continuation of existing programs: for example, increased funding of the Local Initiatives Program, on-the-job training and the seasonal capital works project. These initiatives represent a continuation of federal attempts to spend the economy out of the crisis. This approach has failed in the past two years and it will not work now. Expenditure programs such as the recent Winter Works Program have a major disadvantage in that they involve a rather long administrative lag and thus are likely to be quite ineffective in the short run.

I am certain that a substantial federal personal income tax cut would have a beneficial impact on the economy. I believe this initiative would stimulate growth in spending, jobs and incomes; while at the same time having a very real and psychological anti-inflationary effect on the economy. It is long overdue. In contrast to the beneficial effects of a federal tax cut, it is our opinion that, at this time, tax increases by the provinces and municipalities

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10. Rt. Hon. P.E. Trudeau, Speech from the Throne, Commons Debates, Ottawa, January 4, 1973.

would both depress the economy and contribute to the resurgence of inflationary pressures.

I urge, therefore, that the federal government immediately introduce a reduction of $1 billion in its personal income tax. Further, I recommend that this tax cut be permanent, and that a change in tax-sharing arrangements be worked out to allow the provinces to move in to take up some of the tax room made available by the reduction.

Let me emphasize that my first concern is to see a robust economy. I earnestly believe the federal government can well afford to take this initiative to stimulate the private sector. Our estimates indicate that over one-half of the $1 billion tax cut would be recouped in fiscal 1973-74 through its expansionary effect on incomes and jobs. That is, revenues will be higher and U.I.C. benefit payments lower. After two years, the cost will be more than completely recovered. A similar experience was found in the United States in 1962 after a U.S. income tax cut. In fact, if Canada can get down to 4.0 per cent unemployment, the federal government could save a substantial part of the cost of the tax cut in reduced advances to the U.I.C. alone.

Let me emphasize that we are not asking the federal government to sacrifice its own programs or priorities. We are simply asking you to relinquish the unintended revenue gains from tax reform. This abatement in taxes will not impair the ability of the federal government to fulfill its role in stabilizing the economy. Rather, it will put the provinces on a sounder financial footing and allow them to complement federal stabilization actions in the future.

III REFORM OF TAX SHARING

In calling for a significant income tax cut by the federal government, Ontario has kept in mind the crucial links between tax reform, tax sharing, and fiscal policy co-ordination.[11] As I have said, a tax cut at this time would be stimulating, non-inflationary and self-financing. It would also establish the basis for fundamental reforms in our system of federal-provincial finance. Specifically, a tax cut would:

- make available immediate tax room for the provinces and reserve additional room to take up when the economy has recovered;
- arrest the growth of the public sector by containing tax levels; and
- help to restore greater uniformity in income tax levels within Canada.

Fiscal Imbalance

The basic problem facing our federal system today is the fact that the federal government is overfinanced while the provinces and municipalities are underfinanced. This imbalance was documented in the Tax Structure Committee Report of 1966 and has been confirmed in subsequent updatings and by other studies.

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11. Hon. Charles MacNaughton, Ontario Proposals for Tax Reform in Canada (Toronto: Department of Treasury and Economics, 1970).

The evidence proves that the federal government's revenues have consistently exceeded its own-account expenditures. Data for recent fiscal years indicate, in fact, that the federal government would have been in an even stronger financial position had the economy not performed significantly below potential, necessitating large payouts in respect of unemployment insurance. Our analysis of federal budgetary trends confirms that even with low economic performance federal revenues will grow at least 5 per cent faster than expenditures in the years ahead.

In contrast, the expenditures of the provinces and municipalities have long exceeded their revenues, leaving them in a state of chronic deficit in spite of regular tax increases. The provincial-municipal sector is already underfinanced by more than $3 billion in 1972-73. Without additional tax sharing this position will continue to deteriorate, since expenditure growth continues to outstrip normal growth in revenues.

Income tax reform has served to reinforce the surplus revenue potential of the federal government. The revenue gains resulting from the higher elasticity of the new income tax system are already evident from the revenue flows

during 1972.[12] As Ontario showed in the papers it tabled at the Jasper Conference of Finance Ministers, these revenue gains accrue almost entirely to the federal government. Consequently, the provinces have been presented with a de facto loss in tax sharing.[13]

The federal government's five-year revenue guarantee in effect acknowledges this loss in tax sharing, but to date no steps have been taken to counter the long run deterioration of the provincial position. At a more general level, the inadequacy of the Canadian revenue sharing system - and its deterioration under tax reform - is demonstrated by the fact that eight provinces have been forced to levy personal income taxes in excess of the 30.5 per cent "recognized" for sharing purposes by the federal government.

The surplus taxing power accumulating in the hands of the federal government has enabled it to exert financial leverage on the provinces by initiating new shared-cost programs, many of which are not in accord with provincial

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12. Ontario's quantitative studies during the tax reform debate predicted this increased elasticity. See Ontario Tax Studies 4, Tax Reform and Revenue Growth to 1980 (Toronto: Department of Treasury and Economics, 1971).

13. Hon. W. Darcy McKeough, Supplementary Papers on Federal-Provincial Finance (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, March 28, 1972) pp. 10-14.

priorities. At the same time that Ottawa has been enjoying large fiscal dividends, provincial and municipal revenues have not grown fast enough to finance existing programs, let alone to meet emerging priorities such as urban transportation and environment improvement. Indeed, the situation is so serious that Ontario has been forced to make massive expenditure cutbacks and to defer additional financial aid to our local governments. The current imbalance is most graphically displayed by the fact that the Ontario Government faces a $1.1 billion cash deficit in 1973-74, even after severe expenditure restraint. This exceeds the potential deficit which the federal government faces for Canada as a whole.

Consequences of Fiscal Imbalance

Barring a significant transfer of tax resources from Ottawa to the provinces, Ontario will be forced to raise its own taxes, merely to finance the essential public services for which it is responsible. But it is clear that such unilateral provincial tax increases are not the answer to the problems confronting us. The consequences of such an approach would be ominous indeed.

First, this would entail higher income tax burdens for our citizens, and we believe that tax levels are already very high. Moreover, since many provincial levies have a regressive incidence, increased provincial taxation would tend to negate the equity objective of federal and provincial tax reform programs. Ontario's successful effort to resist income tax increases has been an important anchor against the tide of ever increasing total tax burdens.

Second, federally induced provincial tax increases combined with continued federal program invention would lead inexorably to an expansion of the public sector. One adverse consequence of this would be increased inflationary pressures. Ontario has consistently taken the position that the total government sector is already large enough, and that it ought to be contained near its present level.[14]

Third, unilateral provincial tax increases would lead to a further balkanization of the national tax structure. Over the years, disparity in income tax burdens within Canada is likely to widen as different provinces are driven by financial necessity to regular tax hikes.

Finally, independent taxing would increase the likelihood of provinces inadvertently offsetting federal

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14. Hon. Charles MacNaughton, "The Public Sector and Economic Policy", Ontario Budget 1970 (Toronto: Department of Treasury and Economics, March 1970).

policy. In the past, Ontario has used the limited budgetary flexibility at its disposal to initiate required stabilization action and to complement federal efforts. Now Ontario no longer has the financial resources to undertake complementary tax cuts when they are required to stimulate economic activity. Accordingly, we must point out that without fiscal realignment provinces could be forced into tax actions which counteract expansionary policies undertaken by the federal government.

Ontario's Solution

To avoid such adverse developments, Ontario has presented a plan for an orderly reform of the tax-sharing system. Our proposals were first presented at the Jasper Conference and have been reiterated several times since. The Jasper proposal called for a staged reduction in federal income tax by 3 per cent in 1973 rising to 6 per cent in 1974, 8 per cent in 1975, and 10 per cent in 1976.[15] The standard provincial tax rate would be increased by comparable steps until it reached 40.5 per cent in 1976. This timetable of federal income tax reductions and compensating provincial increases follows essentially the same pattern as the staged abatement increases of the early 1960's. This approach would correct the existing fiscal imbalance

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15. Hon. W. Darcy McKeough, Supplementary Papers on Federal-Provincial Finance, *op. cit.*

without increasing total tax burdens, and would achieve a fairer division of future revenue growth between the two levels of government.

The first step towards this overdue reform of tax sharing was called for by Premier Davis in a letter last month to the Prime Minister of Canada. Mr. Davis urged a continuation of the 3 per cent federal tax cut and a further 4 per cent federal tax cut effective immediately, which would be taken up by the provinces to achieve improved tax sharing. This strategy would take into account the need for fiscal stimulation of the economy and would also help to avoid the otherwise inevitable increases in the total tax burden in Canada.

At this meeting here today, Ontario is calling for a $1 billion income tax cut, consisting of a continuation of the 3 per cent cut now in effect, plus a further cut of 6 per cent to be effective immediately. This simply accelerates the long-term plan Ontario advocated in Jasper in order to provide the major fiscal stimulus which the economy so urgently needs. Our current proposal would provide a 5 per cent tax cut to taxpayers plus 4 per cent of income tax room for the provinces to take up in 1973. Then, as the economy improves in 1974

and beyond, provinces could gradually assume the 5 per cent additional occupancy already reserved. This plan does not imply an impairment of federal ability to finance its own expenditures in the long run. The savings in payments to the U.I.C. fund and the revenue growth generated from increased economic activity will quickly restore the absolute level of federal financing.

The Shared-Cost Programs

From a longer-run point of view, refinancing of the government sector involves reforming the shared-cost programs. Experience both here and abroad indicates that conditional grant programs interfere with provincial priorities, are administratively inefficient and are relatively unresponsive to local needs.[16] Ontario has indicated that it would like to opt out of the major shared-cost programs in exchange for an increased share of the personal income tax. In its Jasper papers, Ontario proposed that a reasonable long-run adjustment would consist of a transfer of 21 points of the personal income tax to the provinces. This fiscal equivalence would provide no financial gain or loss to either level of government but would achieve the accountability, flexibility and simplicity so obviously needed in this

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16. Ontario Tax Studies 8, Federal-Provincial Shared-Cost Programs in Ontario (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1972).

area of federal-provincial finance.

Conclusion

It must be stressed, in conclusion, that we have now reached a critical juncture in federal-provincial relations. The time has come for a bold fiscal initiative to stimulate the economy and to rectify the financial imbalance undermining our federal system. The major cut in federal income tax that I advocate is the key for meeting these multiple objectives.

The recent course of events makes two things clear. The federal government must move in and use the full weight of its fiscal power to reactivate the economy to full employment. And the provinces must inevitably secure a larger share of total income tax revenues to finance essential local services.

The plan Ontario has advanced would achieve both these essential reforms in a way which serves the interests of all of our citizens. We offer this plan in the spirit of good will and assure you of our co-operation if the federal government adopts this proposal.

Thank you.

Ontario